The loss of output in the two recessions of the 1980s has been quite close to what some recently estimated conventional economic models would have predicted if inflation was to be reduced by about the three percentage points it has fallen since 1980. This relationship, often known as the "Phillips Curve," was estimated during the 1970s to require a cumulative sacrifice of 10 percent of a year's GNP in order to achieve a permanent one-percentage-point reduction in the inflation rate. A more recent estimate puts the output sacrifice lower, at around 5 percent of a year's GNP. The cumulative loss of GNP since 1979 may be between 15 and 20 percent of a year's GNP, depending on how much GNP might be assumed to have increased in the absence of a recession; this is consistent with an inflation reduction of between 1.5 and 4 percentage points. The actual reduction, as noted above, is about three percentage points, and is likely to be permanent. 7/

The lack of economic growth since 1979 has brought the unemployment rate to nearly 11 percent, the highest level in 40 years, and nearly five percentage points higher than in 1978-1979. As in earlier recessions, almost all the increase in unemployment was among people who had formerly been employed, rather than among new entrants to the labor force. (Chapter V discusses the current labor market situation in detail.)

Business Fixed Capital Formation. Recessions usually cause a decline in investment, both because corporate profits are low and because there is little incentive to purchase new equipment when existing equipment is idle. In most postwar recessions, business fixed investment has dropped (in percentage terms) about twice as much as output. Investment has also fallen during the current recession, but by less than in the past. In the early part of the recession (from the third quarter of 1981 to the first quarter of 1982), business fixed investment dropped only a little. This may have been because businesses believed the consensus forecast that the recession would end early in 1982, and because the tax cut boosted cash flows. As it became clear that the recession was not over, investment (particularly in business equipment) fell rapidly during 1982. And surveys of investment plans in the fall of 1982 suggest a further 5 percent or so real decline in investment in

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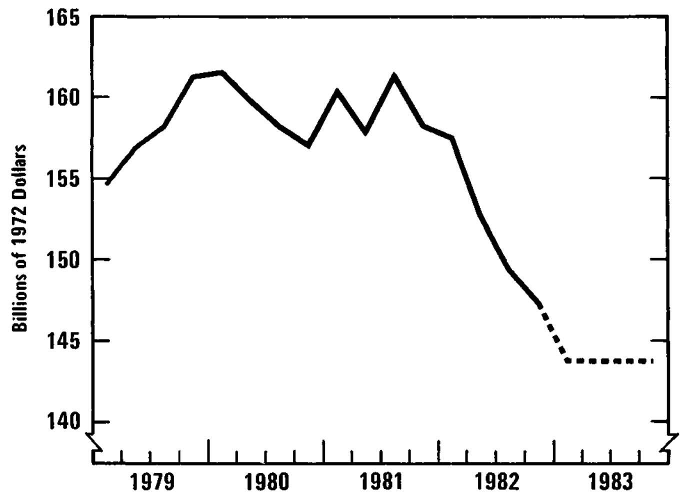
7/ See Arthur Okun, "Efficient Disinflationary Policies," American Economic Review, vol. 68, no. 2 (1978), and Robert J. Gordon and Stephen R. King, "The Output Cost of Disinflation in Traditional and Vector-Autoregressive Models," Brookings Papers on Economic Activity, 1982:1, pp. 205-44. See also Chapter V of this report.

Figure 12.
Plant and Equipment Spending



SOURCE:
U.S. Department of Commerce, Bureau of Economic Analysis.

new plant and equipment in 1983. 8/ Current economic forecasts do not predict strong growth in 1983, and hence there may be little improvement in capacity utilization that would lead to upward revision in spending plans (see Figure 12).

The current recession contains two new factors: high real interest rates and new tax incentives for investment.

- o Real interest rates, which determine the profitability of borrowing to finance new investment, usually fall during recessions, and in fact usually become negative. 9/ Since 1980, real interest rates have been at unprecedentedly high levels: even the declines in rates since the summer of 1982 left real rates on long-term bonds in the neighborhood of 7 percent at the beginning of 1983. This is a powerful disincentive for investment.

8/ Business investment spending on a National Income Accounts basis often recovers from a recession faster than the plant and equipment spending plans survey suggests. But the outlook for the segment of business spending reflected in the survey remains bleak.

9/ Real interest rates are interest rates adjusted for expected inflation. Since expected inflation is unobservable, real interest rates may be approximated by adjusting interest rates for the inflation actually experienced.

- The depreciation provisions of the Economic Recovery Tax Act of 1981 (ERTA) substantially increased the tax deductions available for new investments, and thus increased cash flow and reduced the after-tax cost of investment. And lower inflation means smaller increases in the replacement cost of assets to be financed out of depreciation allowances: this further increases the value of the tax allowances. The depreciation provisions were originally scheduled to become more generous in 1985, but this was cancelled by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). At the same time, the arrangements that enabled companies with low taxable profits to benefit from the depreciation provisions through leasing were cancelled. Nevertheless, the new law and lower inflation leave a greater tax incentive to invest, in line with a generally recognized need for more capital formation to create the conditions for long-run growth.

The current high real interest rates probably swamp the more liberal depreciation now available. As noted above, real interest rates are currently at least seven percentage points above their usual level at this point in a recession: this increase is roughly twice as big as the decrease in real after-tax rates resulting from the effects of lower inflation and of ERTA on investment. 10/

Residential Construction. Housing investment has been hit even more severely than business fixed investment. During the 1970s, construction of single-family homes boomed in order to satisfy a rapidly growing demand for owner-occupied housing. Recent high mortgage rates have reversed this trend, putting housing out of the reach of many people. To give an idea of the magnitudes involved, a purchase of a typical new single-family house in 1970, financed by a 30-year fixed-rate mortgage for 75 percent of the value of the house, would have cost about $171 per month, or 20.8 percent of median family income. 11/ By 1979, that ratio had risen to 30.2 percent, and by early 1982 to 44.2 percent. By this time, financing the purchase of the same typical house cost about $853 per month, five times as much as in

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10/ Economic Report of the President, February 1982, p. 123. The discussion on that page calculates that the real before-tax rate of return required to justify new investment at a fixed real after-tax interest rate has fallen by about three percentage points as a result of lower inflation and ERTA.

11/ A typical house is a house like the average house sold in 1977.

1970. The recession, too, has discouraged house purchases both by holding down household incomes and by increasing the probability of unemployment and the consequent risk of defaulting on mortgages.

The result of these factors has been to reduce single-family housing starts from 1.2 million units in 1979 to about 700,000 units (annual rate) in the second half of 1982. Multi-family starts have not fallen quite so much, since they have not depended on the ability of individual homeowners to finance purchases at high mortgage rates. Several government programs, too, have helped to support multi-family housing starts, while ERTA has offered improved tax treatment of rental housing.

Recent data on house sales and housing starts suggest that this sector is on the road to recovery. Since interest rates turned down in mid-1982, single-family starts have increased by about 150,000 units at an annual rate. This improvement presumably reflects the easing of mortgage payments with lower nominal interest rates, since real rates remain very high. The carrying cost for purchase of a typical house has so far fallen only a little, to about 38 percent of median family income, but further declines in mortgage rates are expected.

Financial Strains. Bankruptcies, loan defaults, and loan delinquencies have risen to record levels in this recession.

Nonfinancial corporations have had to defend their solvency on two fronts: the recession has cut into sales and profits, while at the same time high interest rates have eaten into corporate cash flow. Recently, interest rates have declined and profits have begun to improve. But the risk that interest payments will be a burden on cash flow now seems likely to continue through the early years of the recovery. Most recessions, as noted above, reduce real interest rates to zero or below, giving corporations the opportunity to lock in low interest rates by funding their short-term debt with money borrowed long term. In normal recessions, the ratio of long-term to short-term debt increases, protecting the corporation from higher interest rates as the economy recovers. In the current recession, however, real-long term rates have stayed at unprecedented levels (see Chapter IV), so that corporations have not been able to refinance at low rates.

Many financial corporations are also experiencing severe strains. Thrift institutions, which borrow short-term money from depositors and lend it long, have been faced with increases in short-term rates that have not been matched by increases in the returns on their assets. The progressive deregulation of the thrifts has permitted them to offer new accounts that enable them to compete effectively for funds, and thus the traditional loss of thrift deposits (disintermediation) as short rates rise has been largely avoided. But book profits have been wiped out by the consequent increase in the cost of funds used to finance fixed-rate asset portfolios. And many financial institutions would now have negative worth if their assets were carried at market rather than at book value.

AN INTERNATIONAL RECESSION

Other countries have, like the United States, suffered from faltering growth, contracting world trade, and difficulties in adjusting to the consequences of generally anti-inflationary policies. In many respects, the global economy mirrors the ills of the U.S. economy with generally restrictive policies that have engineered the world's most prolonged recession since World War II. The global economic consequences of these policies and the resultant recession have been severe:

- World trade has contracted sharply as other economies have adopted restrictive policies. Unlike in the U.S., fiscal as well as monetary policies have generally been tightened.

- The escalation in world interest rates, has brought about major realignments in international currency values. U.S. rates have risen even more than the others, with the result that the dollar has soared in the past three years.

- The global recession, soaring world interest rates, and a rising dollar exchange rate, have exacerbated already difficult international debt service obligations for most developing economies and created the risk that debt defaults will shake the stability of the domestic and international financial systems.

Since World War II, U.S. policies have promoted and the U.S. economy has benefited from the increasing integration of world trade and financial markets. Integration means, however, that each economy is more exposed to what happens elsewhere. The current recession has shown how open the U.S. economy is to the influences of global economic activity, and how sensitive other economies are to the policies of the United States.

Industrial Economies. Economic activity in all of the industrial economies weakened to an unexpected extent during 1982, and the volume of world trade contracted. Unemployment in the United States and in European industrial countries exceeded 10 percent by the end of the

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year. 12/ This dismal performance was in large degree caused by similar restrictive policies pursued simultaneously by all countries, generally with more negative effects than intended. Nevertheless, these policies were more successful in reducing inflation than many had thought probable (see Figure 13).

Much of the downturn in global economic activity stemmed from restrictive U.S. credit conditions. The U.S. recession reduced U.S. demand for imports, diminishing employment and output abroad. High U.S. interest rates attracted foreign money to dollar-denominated assets here and abroad. To counter the damaging effects on exchange rates of these massive shifts into dollars, other countries adopted restrictive monetary policies and their interest rates soared.

It would be an overstatement, of course, to argue that the current condition of the global economy is attributable solely to U.S. policies. A consensus had developed in the industrial economies that inflation should be reduced, and that reductions in spending by central governments were necessary for long-term viability. Most foreign governments consequently urged the United States to adopt anti-inflationary policies, and have done so themselves.

The coming years look fairly bleak for many industrial countries. The United States, which has often been the locomotive of the Western economy, is not likely to provide much forward momentum. Trade volumes are likely to be weak and a traditional recovery--industrial nations exporting their way out of a recession--may be difficult to achieve since all are simultaneously at the trough of the business cycle. Even the Japanese economy, which has weathered the 1970s best, is now in for harder times. Its exports, which have provided much of Japan's real growth in recent years, are stagnating while domestic demand continues flat. In Europe, the coming year is likely to see some difficult policy efforts to deal with unemployment, which stands at unprecedented levels. Job creation has not kept pace with the growth of the labor force for several years now, and labor force growth is likely to increase in the next few years.

The slump in world trade raises the danger of a surge in protectionism. Recessions lead to pressures on governments to maintain domestic employment by establishing barriers to foreign goods or subsidizing domestically

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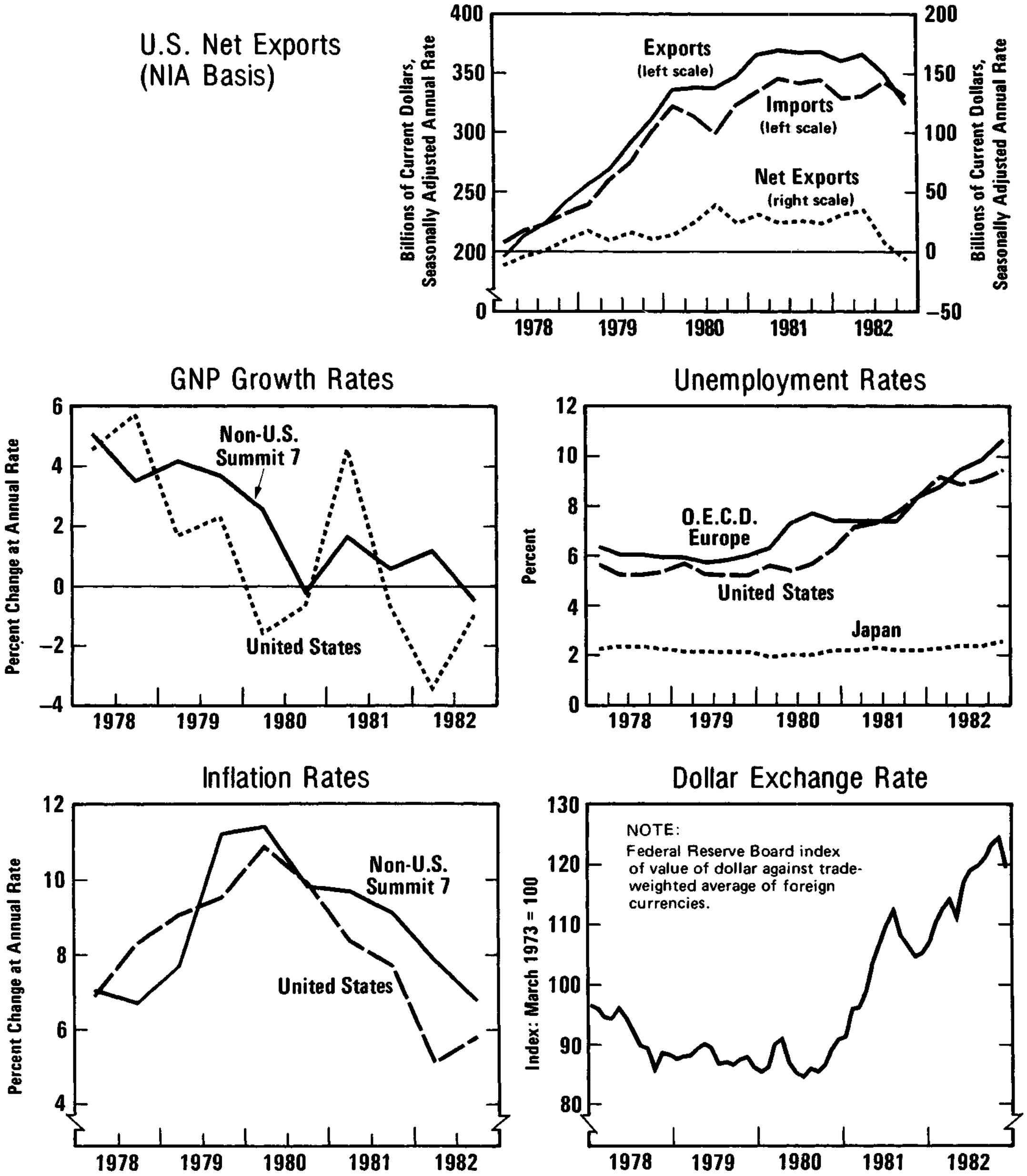
12/ Japanese unemployment rates, which have remained relatively stable, are not directly comparable with those for the United States and Europe because of economic, social, and statistical differences.

Figure 13.
International Economic Indicators



SOURCES: Organization for Economic Cooperation and Development; U.S. Department of Commerce, Bureau of Economic Analysis; Federal Reserve Board.

made goods. Considering the severity and duration of the current recession, such protectionist measures have been fewer than might have been expected.

In the United States, protectionist sentiments are particularly acute with respect to Japanese manufactures (especially autos), and the agricultural and steel trade policies of the European countries. The "reciprocity" and the automobile domestic content bills considered--but not enacted--by the Congress during 1982 were manifestations of these sentiments. Nor are foreign economies immune to the protectionist clamor. Japan, on its part, is about to invoke its 62-year-old antidumping law for the first time in history against surging textile imports.

Foreign Exchange Rates. The dollar remains strong in comparison to other currencies, reflecting relatively higher real interest rates in the United States. The Federal Reserve weighted-average exchange rate index for the dollar against its ten largest competing currencies has appreciated over 40 percent since mid-1980 (see Figure 13). Other currencies, especially those of developing economies struggling with huge levels of dollar-denominated external debt, stand much lower in terms of the dollar. The dollar exchange rate will most likely fall over the coming year as U.S. interest rates decline and the U.S. trade position deteriorates further, but the magnitude of the decline is uncertain.

The dollar's strength has also been sustained by unusually strong dollar demand combined with weak supply as evidenced by:

- A continued demand for dollar assets due in part to capital movements (including "capital flight" from developing countries) based on perceptions of economic and political instability;

- A continued demand for dollar loans resulting from developing-country debt service problems;

- A slowdown in international credit flows resulting from tight credit conditions in the United States and retrenchment by U.S. banks as well as banks in Europe and Japan.

Tight credit conditions in the United States constrained the global dollar supply in the first half of 1982. However, a decline in the volume of net capital outflows in the third and fourth quarters reflects reluctance of U.S. banks to commit funds for international lending. Though domestic credit has increased, it is being absorbed by domestic borrowers, with the Treasury requiring a large proportion of it. This has resulted in a continued constraint on the supply of dollars available to foreign investors and borrowers. Even though U.S. interest rates fell in the second half of 1982 and narrowed the U.S.-foreign interest differential, the dollar exchange rate continued to rise.

The continued strength of the dollar has depressed growth in U.S. exports and permitted relatively stronger import penetration than would normally occur given the sluggish domestic economy (see Figure 13). Since trade effects lag behind exchange rate movements, a further deterioration in the U.S. trade balance is likely over the next two years. This will lead to some turnaround in the value of the dollar as against other currencies in 1983 and 1984. But a return to the dollar's 1980 values--a reversal of some 30 percent--is unlikely if a differential between U.S. and foreign interest rates continues and if U.S. monetary authorities tighten monetary aggregate targets at any sign of renewed inflation.

<u>Developing Economy Debt Problems</u>. The global recession, which has posed such large problems for the industrialized economies, has had even more severe consequences for the developing countries. The scope of their financial problem is suggested by the following:

- The aggregate current-account deficits expected for the developing economies in 1982 will exceed $75 billion. In 1983 and for some years to come, these deficits may exceed $50 billion. The deficits represent more than a doubling of their external balance shortfalls of the mid-1970s.

- Nearly half of the external debt of the developing economies--estimated at $650 billion at year-end 1982--is of less than one-year maturity, suggesting that an increasing volume of refinancing will be required in 1983.

- A record 22 debt reschedulings occurred in 1982, involving more than $45 billion of loans--up from $10.8 billion for the 14 reschedulings of 1981.

- For many of the major borrowing countries (such as Mexico, Argentina, Brazil, and Poland), 1982 debt service ratios--amortization and interest payments relative to exports--were in excess of 100 percent. A ratio in excess of 25 percent is normally considered risky.

In the mid-1970s, the developing economies increased their external borrowing. They were motivated by the need to finance higher-cost oil imports, by easier access to private international financial markets that were recycling the surplus funds of the OPEC countries, and by what appeared to be better economic prospects for many developing countries.

Toward the end of that decade, however, a disastrous sequence of events occurred:

- o World oil prices soared again in 1979, increasing developing economy import bills, while commodity markets in general slumped in 1980, shrinking their export earnings.

- o The global recession of 1981-1982 shattered the economic development plans of the developing economies when demand for their exports dwindled.

- o The substantial appreciation of the dollar after 1980 made the largely dollar-denominated external debt of the developing economies more expensive to service in terms of local currencies.

- o Finally, the favorable interest rate terms initially enjoyed by these economies turned markedly unfavorable as the increasingly short-term, variable-rate debt had to be rolled over.

Some developing countries--Mexico and Argentina are extreme cases--may experience sharp economic contractions possibly threatening their political stability and future creditworthiness. The effect on developed countries, many of which send over a third of their exports to the developing world, could be severe. Over 38 percent of total U.S. exports in 1981 went to the developing economies--as much as was exported to the combined markets of Japan and Europe. U.S. exports to the developing economies for 1982 could be off as much as 10 to 20 percent, representing a 4 to 8 percent reduction in U.S. exports. Many of these exports are intermediate inputs into the production processes underlying development for these economies, so the base for renewed developing economy growth, and hence demand for future U.S. exports, is sharply curtailed. Other industrial economies face similar repercussions.

The U.S. Treasury and the Federal Reserve System, working with the Bank for International Settlements, provided emergency funding to help hard-pressed developing economies service their debt in 1982. Subsequently, the International Monetary Fund provided longer-term funding on condition that the recipient countries take measures to reduce their current account deficits. The success of these actions depends on recovery from the present global recession and on continued private commercial bank lending to these countries. Should either of these conditions not materialize, further bilateral and multilateral efforts to shore up these economies will be required. A series of substantial debt defaults by the larger borrowers among the developing economies would strain the stability of the international financial system.

FUNDAMENTALS OF RECOVERY AND GROWTH

Some of the fundamental conditions for economic growth look better now than they have in several years:

- Inflation is lower;
- The financial position of consumers can support an acceleration of consumption growth;
- Inventories are leaner than they were in 1981;
- Trend productivity growth may be somewhat higher;
- Tax and spending programs are now providing substantial stimulus.

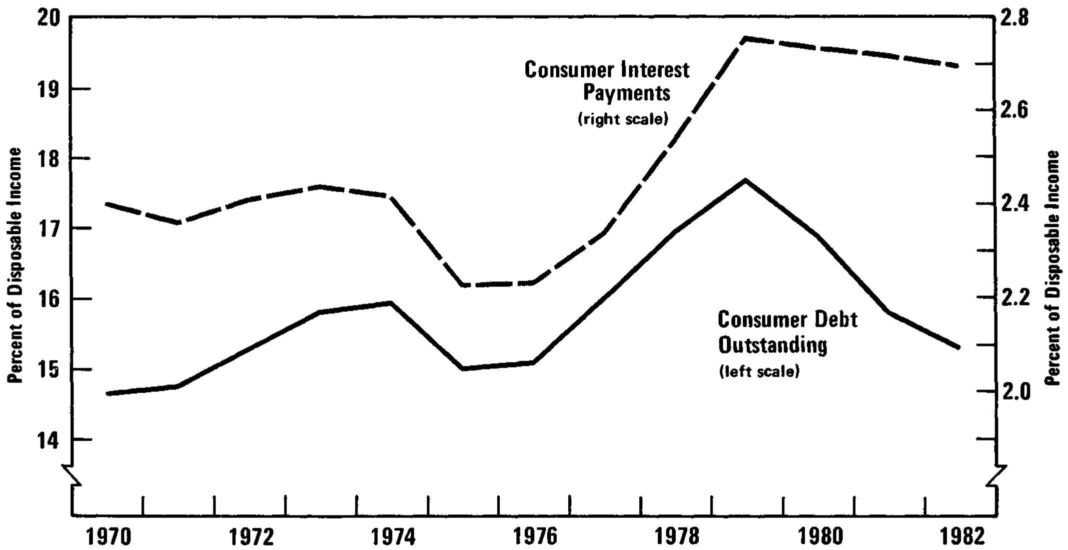
On the other hand, some of the fundamentals still look bad: real interest rates remain high, and the current high exchange rate means that the U.S. competitive position is poor.

Lower inflation reduces the incentive for unproductive and costly inflation-hedging activities (particularly efforts to economize on cash balances, and diversion of loanable funds to excess investment in housing). Lower inflation is also often thought to mean less uncertainty about the future, since when inflation is high people cannot be sure that their incomes will keep up. And if Federal Reserve targets constrain the growth of nominal GNP in 1983 and 1984 (see Chapter IV), lower inflation will make possible higher growth in real GNP. Finally, much of the recent reduction in inflation has come through reductions in the prices of oil and other imported goods, enabling real incomes to grow.

There is some risk that inflation may accelerate as the economy recovers. The risk arises from the possibility that the exchange rate may fall, perhaps by 10 to 20 percent, pushed by the turnaround in net exports. If the Federal Reserve finds it necessary to lower interest rates in order to permit recovery, then the decline in the exchange rate could come faster. This would, by the rule of thumb described earlier in this chapter, add as much as one-half to one percentage point to the inflation rate in 1983 and 1984.

Consumers have cut back sharply on their debt in response to the high interest rates of the past few years: thus, despite higher interest rates, consumer debt service has remained reasonable in relation to current income (see Figure 14). But household net worth has fallen because of high interest rates and the collapse of the housing market. During the 1970s,

Figure 14.
Consumer Finances



SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Federal Reserve Board.

household net worth grew primarily because of the boom in house prices. In the first years of the 1980s, house prices ceased to grow, while rising interest rates meant declining stock and bond prices. As a result, real household net worth fell. But declining interest rates in the second half of 1982 sparked a stock market rally that restored the losses in the stock and bond components of consumer wealth, and lower mortgage rates are likely to do the same for the housing market. Thus consumer net worth probably rose in the second half of 1982.

Although the effects on spendable income of the two tax cuts in the past year were offset by declines in employment (so they had scarcely any noticeable effect on consumption), the next tax cut is expected to be accompanied by rising employment. Surveys show that consumer confidence has improved in the last half of 1982, though this seems keyed to expected improvements in financial conditions in the future rather than to actual improvements in current financial conditions or buying conditions. But the main concern of consumers has shifted from inflation to unemployment as the inflation rate has fallen and unemployment has risen.

Excess inventories which built up in a few industries--notably autos--in 1981 have now been cut. Auto inventories account for much of the recent decline in inventories. Stocks in the hands of dealers remained stubbornly high relative to sales, until they were reduced with the aid of rebates, below-market financing, and other incentives in 1982. A short-lived upturn in sales in May seemed to reflect a surge of buying by people waiting for an incentive program before they made a purchase, but sales then returned to previous depressed levels and unwanted inventory-building resumed. The sharp auto inventory reduction in the fourth quarter of 1982 was made possible only because deep cuts in auto production, coinciding with lower interest rates and new incentive programs, generated a further, and this time apparently more durable, increase in sales. Auto inventories are now low enough to permit resumption of higher production levels.

Inventory levels have not fallen by very much in other sectors during this recession, despite high interest rates and low sales growth. Inventory/sales ratios for manufacturing and trade are thus a little above trend. Farm inventories are at record levels, owing to the excellent 1982 harvest and low demand levels (and despite large Commodity Credit Corporation purchases).

Productivity Growth. There is a possibility, too, of faster underlying productivity growth during the next few years. Underlying productivity growth is what remains after cyclical factors are taken out. It is difficult following the first oil shock, and possibly also following the second oil shock. Several reasons have been put forward for the slowing of underlying productivity growth, and some of these now seem likely to be reversed:

- The oil price increases of the 1970s slowed productivity growth by making energy-intensive capital obsolete, and encouraging producers who used less energy (and perhaps more labor) in production. Oil prices have fallen in the past two years, and significant increases are not anticipated in view of OPEC's difficulty in maintaining the current price.

- The postwar baby boom created a bulge of young people entering the labor force from 1970 to 1980. Thus the average age of the labor force fell over this period, and the growing number of inexperienced workers may have reduced productivity growth. In the 1980s, the labor force is expected to begin maturing: new entrants will be fewer, and the 1970s cohort will gain experience and improve their productivity.

- Rising real interest rates and the recession have completely swamped the impact of the 1981 tax incentives on investment. But if interest rates fall back to a normal range and the economy enjoys a normal recovery, the rate of capital formation could rise and spur productivity growth.

IMMINENT RECOVERY?

Positive Signs

Housing starts surged in the fourth quarter, particularly in November. Some of the increase may have been due to unseasonably good weather so there may be a plateau in later months. But house sales have been rising. and lower mortgage rates have made home purchase more affordable. The increase in starts would add about $ 4 billion in 1972 dollars to GNP in the first quarter of 1983, adding about 1 percentage point to the first quarter (annualized) growth rate. And new home sales will add to home furnishing purchases.

Auto sales responded dramatically to sales promotions in November, and did not drop all the way back in December. The resulting cut in auto inventories supports a planned increase in auto production that could add $6 billion to GNP in the first quarter, or about 1½ percentage points to the (annualized) growth rate.

Inventory liquidations may well be over. Auto inventories have finally been reduced below normal levels and lower short-term interest rates reduce the incentive for further inventory cuts.

Consumer confidence increased markedly at the end of 1982. Attitudes towards market conditions for buying cars and houses were particularly improved, and reflected perceptions of lower interest rates and prices.

The military spending buildup is beginning, and is expected to add about 0.5 percentage points (or $7 billion) to GNP over the next four quarters.

Unemployment may be levelling off. Initial insurance claims fell sharply in early January.

The index of leading indicators has risen for most of the past year, and rose again in December.

Negative signs

The exchange rate remains high, portending further major losses in net exports.

Interest rates are still at record levels compared with current inflation.

Investment plans suggest a further cutback in business fixed investment in 1983. Orders for nondefense capital goods may have stopped declining, but the order backlog is still falling.

Sensitive crude materials prices in December still showed no sign of increased demand. Scrap prices, in particular, fell at an accelerating rate in November and December.

Christmas sales were poor, despite renewed consumer confidence and early seasonal markdowns in November.

CHAPTER III. THE CBO ECONOMIC AND BUDGETARY PROJECTIONS TO THE YEAR 1988

Extremely tight credit conditions during the first half of 1982 deepened and prolonged the recession in the U.S. economy last year. The already severely depressed interest-sensitive sectors of the economy such as housing and automobiles remained depressed, and weakness spread to other sectors of the economy. The domestic situation was exacerbated by, and contributed to, economic malaise internationally as world trade stagnated after its decline in 1981.

The policies adopted during the last two years have pulled the economy in opposite directions: fiscal policy was designed to provide stimulus to the economy while monetary policy was to remain tight. The goals of this policy mix were to move the economy toward a path of sustained growth while at the same time reducing inflation. It was believed that the new credibility of monetary policy would allow it to reduce inflation without stifling recovery, while fiscal policy would lead to a strong upturn in economic performance. The outcome of this combination of policies proved disappointing: Inflation declined sharply, but at the cost of record unemployment.

During this two-year period, tight money was seen to have its traditional effect of reducing inflation while increasing unemployment. Very high interest rates operated to reduce final demands and to bring about a paring of inventories. Housing, investment, autos, and other interest-sensitive sectors of the economy were adversely affected, just as in the past. The impact on the world economy was significant, and fed back on the domestic economy through a rise in the exchange value of the dollar coupled with large reductions in exports. The drop in inflation resulted from (a) a decline in wage gains because of record slack in labor markets, (b) lower prices on product markets as inventories were slashed, (c) lower food and fuel prices, and (d) low import prices because of the strength of the dollar. Most empirical evidence suggests that the decline in inflation was about what traditional economic models would have projected.

Early last year, monetary and fiscal policy appeared to be working against each other. But large actual and prospective federal deficits prompted a partial reversal of the stimulative fiscal policy. The failure of the recovery to materialize, together with rising unemployment and financial strains, also led to a less restrictive monetary policy during the second half of 1982. The Federal Reserve has permitted money aggregates to grow rapidly, and interest rates have trended down. But it is by no means certain that monetary policy can achieve moderate growth with declining inflation, especially in the face of large and persistent federal deficits.

This chapter presents the CBO baseline forecast for 1983-1984 and long-run economic projections through 1988. Because the outlook contains so many uncertainties, CBO also presents two alternative projections through 1988, along with their consequences for the budget. The previous chapter surveyed recent developments in the economy. Issues of monetary and fiscal policy are examined at greater length in Chapter IV.

TABLE 8. THE CBO FORECAST FOR 1983 AND 1984

Economic Variable	Actual 1981	Actual 1982	Forecast 1983	Forecast 1984
Fourth-Quarter to Fourth-Quarter (percent change)				
Nominal GNP	9.6	3.3	8.9	9.6
Real GNP	0.7	-1.2	4.0	4.7
GNP Implicit Price Deflator	8.9	4.6	4.7	4.6
Consumer Price Index Urban consumers	9.6	4.5	4.8	4.8
Urban wage and clerical workers	9.4	4.5	3.8	4.5
Calendar Year Average (percent)				
Unemployment Rate	7.6	9.7	10.6	9.8
3-Month Treasury Bill Rate	14.0	10.6	6.8	7.4

NOTE: Forecast ranges are not shown in this table, despite a very high level of uncertainty in the forecast. Instead, alternative "paths" are given in Table 9.

THE OUTLOOK

The CBO projections for 1983-1984 are a forecast, conditional on current budget policies. The longer-run projections for 1985-1988 are not a forecast but a growth path based on assumptions of moderate noncyclical growth with gradually declining inflation. It is uncertain whether the projected growth path is attainable with tax and spending policies now in place. The projections incorporate the following assumptions:

- Budget policies are those in place at the end of the 97th Congress, including the recently enacted increase in gasoline taxes and all appropriation action to date. The projections also assume the defense spending level for 1984 specified in the 1983 budget resolution. Total federal government outlays, on a unified budget basis, are estimated to be $800 billion in 1983 and $850 billion in 1984.

- In regard to monetary policy, the money aggregate, M2, is assumed to grow at a 9 percent annual rate during 1983 and 1984. If velocity growth is close to the historical average, monetary policy appears consistent with the projection. However, if velocity growth deviates sharply from average historical growth rates (as it did during 1982), CBO assumes that the Federal Reserve will adjust its money targets in an attempt to ensure moderate growth in nominal GNP.

- Food prices are assumed to rise about 4 percent this year and 5 percent next year, and no faster than general inflation thereafter.

- World oil prices, denominated in dollars, are assumed to be flat through 1985 and then to rise at the rate of U.S. inflation through 1988.

- Productivity is assumed to trend upward at 1½ percent a year during the decade. Actual productivity growth is expected to rise above this rate during the cyclical recovery.

Conditional on these assumptions, the CBO forecast (1983-1984) shown in Table 8, and the outyear projections (1985-1988), shown in Table 9, may be summarized as follows:

- The rate of expansion of real GNP, on a fourth-quarter-to-fourth-quarter basis, is forecast to be 4.0 percent over 1983 and 4.7

TABLE 9. ALTERNATIVE ECONOMIC PROJECTIONS (By calendar year)

Economic Variable	1983	1984	1985	1986	1987	1988
GNP (billions of current dollars)						
High Path	3331	3706	4059	4427	4822	5263
Baseline	3266	3580	3903	4221	4540	4878
Low Path	3222	3476	3749	4021	4286	4559
Real GNP (percent change, year over year)						
High Path	4.0	6.0	4.2	4.0	4.0	4.0
Baseline	2.1	4.7	4.1	3.7	3.5	3.5
Low Path	0.8	3.3	3.3	3.2	3.0	3.0
GNP Implicit Price Deflator (percent change, year over year)						
High Path	4.8	4.9	5.1	4.9	4.8	4.9
Baseline	4.6	4.7	4.7	4.3	3.9	3.8
Low Path	4.5	4.4	4.4	3.9	3.5	3.2
CPI-U (percent change, year over year)						
High Path	4.6	5.3	5.0	4.6	4.6	4.8
Baseline	4.5	5.0	4.7	4.1	3.9	3.7
Low Path	4.5	4.9	4.4	3.8	3.4	3.2
CPI-W (percent change, year over year)						
High Path	3.5	4.4	5.0	4.6	4.6	4.8
Baseline	3.8	4.6	4.4	4.1	3.9	3.7
Low Path	4.2	4.8	4.2	3.7	3.4	3.2
Unemployment Rate (annual average, percent)						
High Path	9.9	8.5	7.7	7.0	6.4	6.0
Baseline	10.6	9.8	9.0	8.4	8.0	7.5
Low Path	11.2	10.9	10.3	9.8	9.4	9.0
3-Month Treasury Bill Rate (annual average, percent)						
High Path	4.4	5.4	5.7	5.0	5.0	4.9
Baseline	6.8	7.4	7.2	6.6	6.1	5.9
Low Path	8.4	9.9	8.9	7.7	7.2	6.3

percent over 1984. In the ensuing four years, the baseline path calls for growth averaging 3.6 percent.

- Prices, as measured by the GNP implicit price deflator, are forecast to rise 4.7 percent in 1983 and 4.6 percent over 1984. Inflation then averages 4.1 percent over the next four years.

- The unemployment rate, on a calendar year basis, is forecast to average 10.6 percent in 1983 and 9.8 percent in 1984. Over the next four years, the baseline assumes a gradual decline to 7.5 percent in calendar year 1988.

- Short-term interest rates, as measured by the three-month Treasury bill rate, are projected to average 6.8 percent in 1983 and 7.4 percent in 1984. Over the next four years, the baseline projection calls for an average of 6.5 percent.

It is by no means certain that, over the longer term, the Federal Reserve will be able to achieve moderate growth and declining inflation in the face of continued large federal government deficits and a resumption of private credit demands. This potential conflict represents the key question facing policymakers this year. The baseline projection presumes that a severe conflict between monetary and fiscal policy does not develop. These issues are discussed in more detail in Chapter IV.

Reasons for Recovery

As discussed in more detail in the previous chapter, a number of indicators point to a recovery commencing sometime later this year:

- Residential construction is accelerating. Housing starts, an advance indicator of construction activity, have risen sharply.

- Personal consumption expenditures picked up late in 1982.

- The inventory correction, although larger than anticipated, is thought to be nearly over.

- The easing of credit conditions should raise domestic demands, and the projected recovery abroad should bolster U.S. exports.

- Consumer debt positions have improved and spendable income will receive a boost from the July tax cut.

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- Recent upsurges in the stock and bond markets point to increases in consumer wealth.
- There are thought to be very large pent-up demands for autos and housing.
- Defense spending is expected to be quite strong over the next several years.
- The recently enacted (net) business tax cuts, combined with low inflation, should lead to strong demands for new investment, once final demands pick up.

But other indicators suggest that a sustained recovery may not begin soon, or that it will not be robust by historical standards:

- The near-term outlook for investment is very poor: capacity utilization is at an all-time low and nondefense capital goods orders remain weak.
- Interest rates, adjusted for inflation, remain very high.
- Exports may continue to decline because of weak growth abroad, increasing protectionism, and the burden of debt in the developing countries.
- High unemployment encourages cautious consumer behavior. The resurgence in the demand for autos, in particular, appears to be fragile and dependent on continued price reductions.
- Unemployment will retard income growth, particularly wages and salaries, over the months ahead.

MAJOR UNCERTAINTIES IN THE OUTLOOK

The key to the projected recovery is a continuing downtrend in inflation and an easing of credit sufficient to permit a resumption of economic growth. If financial conditions become somewhat less restrictive, as CBO forecasts, then the personal tax cut scheduled for later this year plus the reductions in business taxes should boost private spending and help the recovery. Over the near term, fiscal and monetary policy may work together to stimulate the economy. However, long-term interest rates are still very high and are restraining growth.